

This PDF is a selection from a published volume from the National Bureau of Economic Research

Volume Title: Financial Sector Development in the Pacific Rim, East Asia Seminar on Economics, Volume 18

Volume Author/Editor: Takatoshi Ito and Andrew K. Rose, editors

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-38684-8

Volume URL: http://www.nber.org/books/ito_07-2

Conference Date: June 22-24, 2007

Publication Date: February 2009

Chapter Title: Comment on "Big Business Stability and Social Welfare"

Chapter Author: Pushan Dutt

Chapter URL: <http://www.nber.org/chapters/c0428>

Chapter pages in book: (372 - 376)

not incidental or some historical accident, but rather a product of policy making, the authors can draw stronger conclusions regarding the motives of the political system (like political rent-seeking, or influencing public opinion to win elections) in its dealings with big businesses.

Further, this research can be extended to examine if the bias toward big business stability varies across countries—is there a difference between rich and poor countries? Or maybe democratic and nondemocratic countries? Perhaps the role played by big businesses in a more democratic country is different than the role played in a less democratic country. I think it might be worthwhile to explore some of these questions.

Overall, this paper is a step forward in closely examining the contribution of the big businesses to the society. This paper also brings forth some important open questions that need to be examined in the future.

Comment Pushan Dutt

Schumpeter first advanced the notion of “Creative Destruction” in his book *Theory of Economic Development* (1912). It was here that he made a clear distinction between innovation and invention. Schumpeter argued that while anyone can come up with an invention, it takes an entrepreneur to see its economic viability and to exploit its potential. The entrepreneur was seen by Schumpeter as an indispensable “hero” and the driving force in a capitalist economy.

The world that Schumpeter invoked was dynamic, messy, intrinsically uncertain, and far from the neoclassical world of equilibriums, steady states, and smooth trajectories. In such a turbulent world, businesses, individuals, and institutions based on earlier innovations are constantly undermined and swept away by new technological and organizational innovations. Growth in capitalist economies is not a smooth process but one of creative destruction. The Schumpeterian notion of creative destruction is much cited, even modeled (Aghion and Howitt 1992; Grossman and Helpman 1991) but has been rarely put directly to an empirical test. This is where this paper makes a very important contribution—by constructing an index of business stability, it shows that countries characterized by big business stability exhibit lower rates of economic growth.

A forthcoming version of the paper in the *Journal of Financial Economics* starts off by asking the question “Is What’s Good for General Motors Good for America?” Surprisingly, unlike the Schumpeter of 1912, the later Schumpeter of 1942 would probably answer this question in the affirma-

tive. Schumpeter in *Capitalism, Socialism, and Democracy* (1942) no longer looked upon the entrepreneur as the sole agent of innovation. He believed that much of innovation was, in fact, performed by teams of people within existing large corporations, with the innovation financed by retained corporate earnings. This allows us to cast this paper as an interesting test of who was right—the early Schumpeter of 1912 who emphasized creative destruction or the later Schumpeter of 1942 who saw a bigger role for stable and large firms. As an aside, the existing literature on innovation has also attempted to tackle this question directly. One of their consistent findings has been that large firms have no advantages in research and development (R&D) and that R&D productivity declines with size (Scherer 1991; Cohen and Klepper 1996).

The paper in this volume starts off by carefully, diligently, and cleverly constructing a variety of big business stability indexes. The alternate methodologies used in the construction of the stability index allow the authors to tease out a variety of interesting results. First, they vary the kinds of businesses (private sector versus public sector, foreign owned versus domestic; financial versus nonfinancial firms) to include in their various lists. Second, they vary the definition of what constitutes survival by checking whether employment in the firms grew at least as fast as gross domestic product (GDP) or whether it managed to retain 10, 25, or 50 percent of their labor force. This allows them to show that the death of old firms (rather than old firms being overtaken by rise of new ones) is the key driver of economic growth. Therefore, the earlier Schumpeter is proved right. The authors are also able to evaluate the relative importance of financial, state-controlled, and foreign-controlled firms in the growth process. While causality remains a concern, as in much of this literature, the authors find that good instruments are difficult to come by. However, by careful choice of time windows, by varying the definitions of stability and through a series of controls for latent effects, they make a convincing case for the creative destruction story. One caveat is in order: the study analyzes growth over the period 1990 to 2000. Given that Schumpeter had longer time horizons in mind when he wrote about creative destruction, and given that we know that it is sustained growth rates that matter, it would be interesting to examine if the results hold over longer time frames.

One concern with these results is that the authors base their stability indexes on an indicator (η_i) that takes the value 1 if the labor force in company i grows as fast as the country's GDP over the period 1975 to 1996. However, the proportion in which firms combine factors and substitute for labor is a choice variable for firms. For instance, we know that firms become more capital intensive or skill intensive as countries grow. So high growth countries are more likely to have $\eta_i = 0$, which again raises questions of causality.

A second set of results in the paper examines the drivers of business sta-

bility—these results have fewer problems with respect to endogeneity and measurement error. The authors show that banking system size, red tape, and civil law (for labor-weighted indexes) increase big business stability and that trade and foreign direct investment (FDI) openness (once we exclude financial and state controlled firms) lower it. The authors also argue that big businesses may capture government and preserve their dominance. However, they do not examine how various political institution variables affect big business stability, which seems an interesting area to pursue. Table 10C.1 shows a regression of their labor-weighted and equal-weighted stability index on four political variables: political instability that captures fluctuations in the degree of democracy (see Dutt and Mitra 2008); leadership turnover in a country without a change in underlying political institutions; a dummy variable for Majoritarian systems; and a dummy variable for presidential systems.

The results show that higher levels of political instability in a country lower the stability of business. Leadership turnover does not seem to play a role nor does whether a country has a Presidential form of government. There is some evidence that countries with majoritarian systems, who are likely to experience more pronounced electoral cycles, (Persson 2002) also exhibit lower levels of business stability. Because political instability has been shown to affect economic growth (Alesina and Perotti 1996), perhaps the authors should also include it as a control in their growth regressions.

Finally, it would be interesting to examine the relationship between per capita GDP (rather than *growth* of per capita GDP) and big business stability. If we plot this relationship (for per capita GDP in the year 2000) and

Table 10C.1 Effect of political variables on big business stability

	Labor weighted	Equal weighted
Political instability	−0.052** (0.027)	−0.044** (0.022)
Leadership turnover	−0.006 (0.023)	−0.007 (0.018)
Majoritarian system	−0.154** (0.076)	−0.071 (0.061)
Presidential system	0.053 (0.109)	0.024 (0.088)
Constant	0.488*** (0.122)	0.368*** (0.098)
No. of observations	38	38
R^2	0.22	0.19

Note: Standard errors are in parentheses.

***Significant at the 1 percent level.

**Significant at the 5 percent level.

regress per capita GDP on business stability (as shown in fig. 10C.1), there seems to be a positive and significant relationship between the two.

However, a closer look at the scatter hints at a nonlinear relationship between per capita GDP and big business stability. Regressing per capita GDP on stability and stability-squared in fact leads to a better fit (see fig. 10C.2).

These results seem to suggest that perhaps there is an optimal level of business stability (equal to 0.66 from the preceding baseline regression),

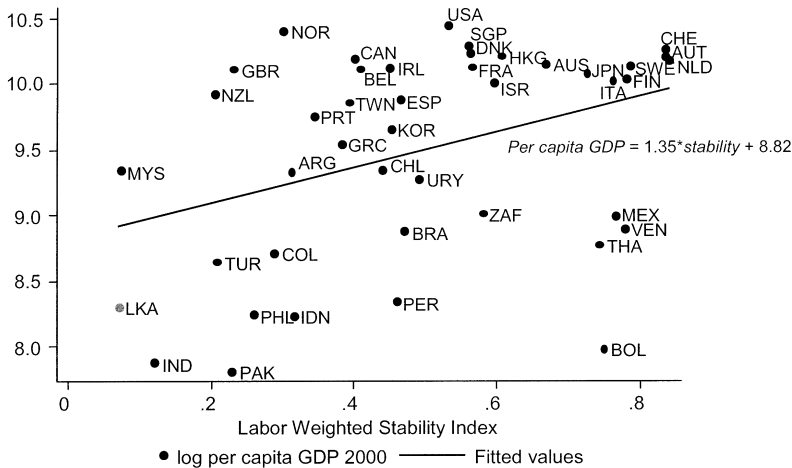


Fig. 10C.1 Per capita GDP and business stability index

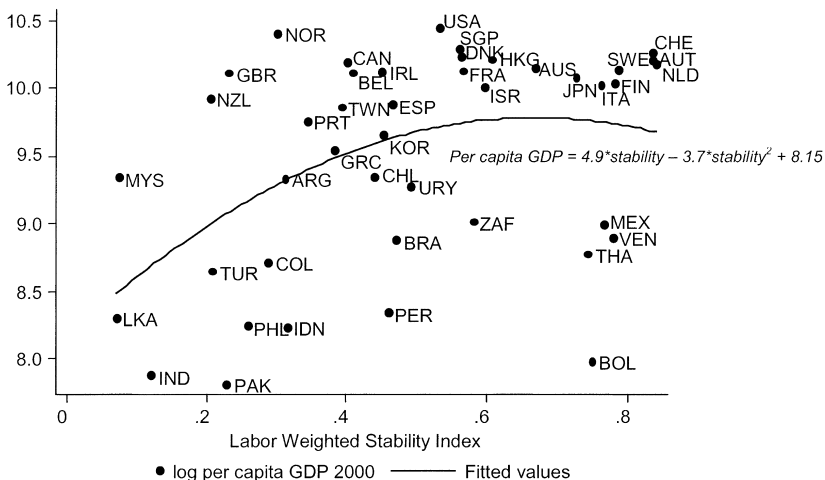


Fig. 10C.2 Per capita GDP and business stability index: A nonlinear relationship

which is approximately equal to that of Australia. A little bit of business stability is good for the level of development, while too much stability may be detrimental.

Overall, this is a very original and interesting piece of work. In addition, there seem to be many interesting questions that remain for the authors to explore in the future.

References

- Aghion, P., and P. W. Howitt. 1992. A model of growth through creative destruction. *Econometrica* 60 (2): 323–51.
- Alesina, A., and R. Perotti. 1996. Income distribution, political instability, and investment. *European Economic Review* 40 (6): 1203–28.
- Cohen, W. M., and S. Klepper. 1996. A reprise of size and R & D. *Economic Journal* 106 (437): 925–51.
- Dutt, P., and D. Mitra. 2008. Inequality and the instability of polity and policy. *Economic Journal*, 118 (531): 1285–1314.
- Grossman, G. M., and E. Helpman. 1991. Quality ladders and product cycles. *Quarterly Journal of Economics* 106 (2): 557–86.
- Persson, T. 2002. Do political institutions shape economic policy. *Econometrica* 70 (3): 883–905.
- Scherer, F. M. 1991. Changing perspectives on the firm size problem. In *Innovation and technological change: An international comparison*, ed. Z. J. Acs and D. B. Audretsch, New York: Harvester Wheatsheaf.
- Schumpeter, J. 1912. *Theorie der wirtschaftlichen entwicklung (The Theory of Economic Development)*. Trans. R. Opie. Cambridge, MA: Harvard University Press.
- . 1942. *Capitalism, Socialism and Democracy*. 3rd ed. New York: Harper & Brothers.